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DEPT PASS OPIC, EXIM, TDA
DOE FOR TOM CUTLER/PI-32 AND JANE NAKANO/PI-42
COMMERCE FOR USDOC 4430--GOLIKE
TREASURY FOR OASIA--ANNA JEWELL

SIPDIS
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SUBJECT: INDONESIA - GOVERNMENT OUTLINES INFRASTRUCTURE PLANS

1. (SBU) Summary: Coordinating Minister for Economic Affairs Boediono and other Government of Indonesia (GOI) officials outlined a wide ranging infrastructure development plan at a February 21 conference for potential foreign investors in Jakarta. Boediono and other GOI speakers described an ambitious regulatory reform agenda through January 2007 that calls for the preparation of seven draft laws and more than 30 regulations to create a predictable and transparent framework for infrastructure investment. In parallel with an improved regulatory framework, the GOI also plans to create an integrated system for developing, tendering, and providing GOI support for selected public-private partnership (PPP) infrastructure projects. Ministry of Finance (MOF) officials outlined an emerging GOI "risk sharing" framework for infrastructure projects, that, when completed, should enable ministries to tender more "bankable" PPP infrastructure projects and provide a mechanism for the MOF to assume limited risk in specific projects. Despite some progress in 2005, Minister Boediono admitted that land acquisition for infrastructure projects remains a major problem, and said the GOI would continue to improve regulations and consider creating a revolving fund to finance land purchases. Several GOI speakers stated the GOI will "fast track" a few high-profile power plant and toll road projects to show international investors that Indonesia is back in business after the economic turbulence of the late 1990s. Private sector conference participants told their GOI interlocutors that they want to see continued regulatory reform, a clear and transparent tender process, a robust financial risk-sharing mechanism, and certainty in land acquisition and titling. Among the GOI's ten priority infrastructure sectors, natural gas pipelines may be the most promising area for international investors in the short-term, but the GOI needs to clarify gas supply questions first. End summary.

2. (U) The Coordinating Ministry for Economic Affairs, Indonesian Chamber of Commerce and Industry (KADIN), and World Bank co-hosted a February 21 conference in Jakarta at which the GOI outlined its infrastructure development agenda and solicited input from potential investors on reforms needed to attract investment to Indonesia's

infrastructure sector. The conference featured breakout sessions on the toll road, transportation, pipelines, municipal water, and electricity sectors with potential investors and GOI policymakers engaging in vigorous dialogue. In his keynote speech opening the meeting, Coordinating Minister for Economics Boediono conceded that the GOI had so far failed to meet the goals of the January 2005 "Infrastructure Summit", and that progress in attracting foreign investors to viable infrastructure projects "has been unsatisfactory." However, Boediono said the GOI has "concentrated its efforts to sort out the problems holding back infrastructure investment," and promised progress by the second Infrastructure Summit tentatively schedule for June 2006.

Ambitious Regulatory Reform Agenda

13. (U) Boediono described an ambitious regulatory reform agenda intended to create a predictable and transparent framework for infrastructure investment. He noted that Presidential Regulation (Perpres) 67/2005 (issued in November 2005) revised the principles governing public-private partnerships (PPP), emphasizing a competitive and open bidding process, clear risk allocation, and tariff structures designed to attract private investment with a reasonable return on investment. Under the umbrella of Perpres 67, the inter-ministerial "National Committee for the Acceleration of Infrastructure Provision" (KKPPI) announced a policy matrix on February 17 listing 153 specific actions the GOI would take through January 2007 to boost infrastructure investment. These actions include the submission of draft laws, the issuance of

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regulations covering ten infrastructure sectors, and the enactment of institutional reforms in GOI infrastructure bodies. Key action items in the matrix include:

--The submission to Parliament of draft laws covering traffic and land transportation (by January 2007), railways (July 2006), shipping (July 2006), aviation (January 2007), electricity (June 2006), postal services (November 2006), solid waste (June 2006), mortgage securitization (June 2006), and regional government-owned enterprises (June 2006).

--The issuance of more than 30 new or revised ministerial decrees or regulations covering a range of infrastructure issues and sectors. These include regulations on foreign loans and grants (by January 2006), tariff policy for PPP projects for all modes of transportation (September 2006), and implementing regulations for Law 38/2004 on Toll Roads (June 2006). The GOI will also issue amendments to Presidential Regulation 36/2005 on Land Acquisition (March 2006) as well as regulations on oil and natural gas upstream and downstream activity by December 2006.

--The adoption of a series of ministerial decrees establishing new or reformed institutions to coordinate the development and implementation of PPP infrastructure projects, including the provision of GOI support. The new institutions include a PPP Center in the KKPPI Secretariat, PPP "nodes" in three key infrastructure

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ministries, and a "Risk Management Unit" (RMU) in the Ministry of Finance (see para 6 below).

--The issue of two key KKPPI decrees scheduled for April 2005 that would establish criteria for the prioritization of infrastructure projects and set up procedures and mechanisms for PPP projects requiring GOI financial support. The former decree would pave the way for a KKPPI list of priority projects eligible for GOI support.

--The preparation of engineering designs, feasibility studies, or tender documents for more than a dozen specific infrastructure projects in the transportation sector. For some projects, construction is scheduled to begin in 2006.

14. (SBU) Forum participants praised the GOI for its ambitious plans, but raised several concerns about the regulatory reform goals during the question and answer period. Some participants expressed concern that the proposed reforms lack specificity and detail, and are piece-meal in nature. They also worried that the timetable for adopting specific laws and regulations in the matrix often extends beyond the date of proposed project tenders in those sectors, making the preparation of high-quality tender documents difficult. Still others expressed lingering uncertainty over the roles to be played by central versus regional government regulatory bodies for many infrastructure projects.

15. (SBU) Suyono Dikun, Deputy Minister for Infrastructure Coordination and Area Development in the Coordinating Ministry for the Economy, told participants that the KKPPPI understands the magnitude of the regulatory reform task, and would sponsor monthly meetings with stakeholders to monitor progress. However, several participants questioned the lack of opportunity for public comment or formal consultations before ministries implement regulations, an important consideration given recent regulatory mishaps and the large number of regulations the GOI plans to enact during 2006. One participant noted the lack of formal consultation mechanisms with the private sector and among GOI ministries creates the potential that forthcoming regulations may fail to address key problems and barriers to investment.

Equally Ambitious Institutional Reform Agenda

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16. (SBU) Boedino, Dikun, and Dr. Anggito Abimanyu, Acting Head of the Ministry of Finance's (MOF) Agency for Economic Analysis and International Cooperation (Bapeki), outlined an equally ambitious institutional reform agenda that, when complete, would create an integrated system for developing, tendering, and providing GOI support for selected public-private partnership (PPP) infrastructure projects. Key elements of the institutional reforms include the establishment of the Risk Management Unit (RMU) at the Ministry of Finance (MOF), a "PPP Center" in the KKPPPI Secretariat, and PPP "nodes" in the public works, transportation, and energy and mineral resources ministries by May 2006. The PPP Center will work closely with the PPP nodes in various ministries to standardize and raise the quality of PPP infrastructure project documents so the projects are more "bankable" for private investors and more suitable for GOI financial support or risk sharing. The Ministry of Public Works' (MPW) experience in recent toll road tenders has shown that without high quality tender documents addressing land acquisition and other risks, very few foreign investors will participate.

17. (U) Dikun said the PPP Center would play an important role as both coordinator and clearinghouse for review and management of infrastructure projects, particularly PPPs. It will also take the lead in managing the regulatory reform process, establishing a national list of priority infrastructure projects, and reviewing specific infrastructure proposals. However, some participants expressed frustration with a lack of clarity in obtaining government review and approvals of projects under the current KKPPPI system, as well as the existing web of

requirements for multiple agency review and approval. KKPPI officials responded that once the integrated PPP system is up and running, investors will not need to go through multiple agencies, i.e. there will be no need to go "shopping around." Under the policy matrix, Minister Boediono is scheduled to issue two key KKPPI decrees in April 2005 establishing criteria for the prioritization of infrastructure projects and setting up procedures and mechanisms for PPP projects requiring GOI financial support.

Risk Sharing Policy Takes a Big Step Forward

18. (U) In their presentations, Minister of Finance Sri Mulyani Indrawati and Abimanyu described in detail the emerging MOF approach to risk sharing or GOI financial support for PPP infrastructure projects. Mulyani cautioned that the GOI's "fiscal space for accepting new contingent risks is limited," and that the GOI would not provide any blanket guarantee because they are "less efficient and tend to create moral hazard." However, she confirmed that the GOI would consider support for high priority projects with clear social benefits. Mulyani said her ministry would issue a decree on a risk management framework in March 2006 that will outline the GOI risk sharing scheme, possible forms of GOI support, and procedures for requesting GOI support.

19. (U) Abimanyu described two key approval processes for obtaining GOI risk sharing or financial support for PPP infrastructure projects the MOF plans to roll out through June 2006. Once implemented, the two should enable ministries to tender more bankable PPP infrastructure projects and provide a mechanism for the MOF commit to limited financial support or risk sharing with private infrastructure investors in specific projects. The two approval processes are:

--A process in which ministries seek "in principle" approval by the Minister of Finance for GOI risk sharing or financial support for individual projects prior to their tendering. The Minister would decide whether to

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offer GOI support based on an evaluation by the RMU. If granted, ministries would include this "in principle" approval in project tender documents, giving potential investors more certainty about the types of risks they must bear in a particular project.

--After the conclusion of the tender process and announcement of a winning bidder, the MOF would grant final approval for GOI financial support or risk sharing for individual projects. This process would follow evaluation by the RMU and the MOF-Chaired "Infrastructure Provision Risk Management Committee", a body with thirty members who serve on an ad-hoc basis. The process would conclude with the signing of a contract with the investor.

110. (U) Abimanyu stated that to guide its evaluation of project risk, the MOF would develop a "risk matrix" that would analyze the major risks faced by infrastructure projects in each sector, and outline possible mitigating strategies, including GOI support or partial guarantees. He grouped risks facing investors into five general categories:

--Sovereign Risk: The risk of expropriation or confiscation of assets or changing composition of ownership due to political pressure.

--Project Performance Risk: Unanticipated changes in laws/regulations causing substantial cost consequences for the private party. This includes site risk (land

acquisition, land price increase, environmental issues); design, construction and commissioning risk; and operational risk (tariff adjustment, maintenance, technical obsolescence).

--Market Risk: The risk that investors may not be able to convert local currency revenue into foreign currency, or face restrictions on the amount they can transfer or repatriate. Also includes risk from competition, general economic downturn, demographic change, and inflation.

--Default Risk: A state-owned enterprise (SOE) fails to meet its payment obligation. This is a key issue in the electric power and gas sectors, where SOEs are monopoly or near-monopoly buyers.

--Force Majeure: War and natural disaster, for example.

¶11. (SBU) Abimanyu noted that the GOI plans to begin consultations with Parliament shortly on securing a budget allocation to cover possible GOI financial contributions to PPP infrastructure projects, as well as the contingent liabilities posed by the GOI's acceptance of certain risks in projects. This process will likely move forward as part of the annual budget process, which begins with the formulation of spending priorities by the State Ministry of National Development Planning (Bappenas) in March of each year, and concludes with the President's annual budget speech in August. Depending on the type of GOI support, the MOF would either hold funds in a central contingency fund (similar to the current budget contingency fund for natural disasters), or include them in the budget of line ministries or other institutions.

Critical Need for Certainty in Land Acquisition

¶12. (U) Boediono underscored that resolving land acquisition bottlenecks remains a critical issue for accelerating infrastructure development, and that ideally land should be available before tenders open. If not, investors will lack certainty needed in bidding on a project because they "can never be certain how long acquisition will take or how much the land will cost." While noting that Perpres 36/2005 had mitigated the problem, Boediono and other GOI speakers outlined several

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measures the GOI plans to take to further speed land acquisition:

--The GOI will revise Perpres 36 by March 2006 to facilitate infrastructure development projects, particularly those that require a right of way.

--The National Land Agency (BPN) will issue implementation guidelines for land acquisition by April ¶2006.

--The GOI will consider establishing a revolving fund for land acquisition so that the GOI could purchase land needed for infrastructure projects before they go out to tender. Under the revolving fund, winning bidders for infrastructure projects would reimburse the GOI for land acquisition costs related to the project. The GOI would then use these funds to purchase land for subsequent infrastructure projects.

¶13. (U) A number of participants raised concerns over the lack of clarity of land acquisition regulations, an issue of particular concern for toll road and pipeline projects. Perpres 36/2005 provides a 90-day timeline for acquisition and formation of a compensation committee. However, the regulations lack specificity on composition of the committee, what agencies will control the

appraisal process and award of compensation, and what parties are entitled to comment on the compensation process. As a result, lengthy delays in land acquisition have been the norm.

¶14. (U) Several participants also strongly disagreed with the idea that land acquisition risk should rest solely with the investor. They recommended the GOI designate a single entity to oversee the land acquisition process for all infrastructure projects. To avoid delays, participants suggested the GOI could provide initial payments to landowners based on a preliminary appraisal, allowing a project to move forward. Any appeal by the landowner on the amount of compensation would then occur after transfer of title. However, several participants pointed out that the viability of this process assumes courts would review valuations in a consistent and fair manner, and that the government would bear the risk of a court requiring a higher payment to a landowner.

Marquee Projects on Fast-Track

¶15. (U) In a step long urged by investors, Coordinating Minister Boediono and Abimanyu made special mention of a GOI decision to "fast track" several high profile projects that could serve as model deals and raise Indonesia's profile in the international investment community. Boediono said the GOI recognizes the difficulties it faces in bringing Indonesia's infrastructure tender system up to world class standards. By getting a small number of demonstration projects off the ground quickly on terms attractive to international capital markets, Boediono said the GOI hopes to create model deals that it could replicate in the future. He added that getting a few model deals would also show the world that Indonesia "is back from the financial crisis and ready to do business."

¶16. (SBU) Abimanyu stated that as part of the fast track program, the GOI would begin the evaluation process (for risk sharing purposes) of the 600 MW Cirebon steam power plant project (tender launched in September 2005) and one or more toll road projects. For these projects, Abimanyu said the MOF would evaluate risk based on current GOI procedures and seek to add contingency funds to the 2007 budget to cover any contingent liabilities.

Transportation Sector

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¶17. (U) Seaport and airport development remain the GOI's top priorities in the transportation sector. Ministry of Communications Director General for Sea Transportation Hariyogi focused his remarks on the proposed development of a hub container port in Bojonegara, West Java. However, several participants suggested that investment in Bojonegara may be a misplaced priority. They recommended the GOI instead focus on developing existing basic infrastructure and operations, improving port management and efficiency, and implementing a national port policy, factors more critical to Indonesia's attractiveness as a destination for international shipping companies and port investors/operators. Noting that the shipping industry itself is now the largest investor in port development worldwide, industry representatives encouraged the GOI to tackle several additional priorities to draw in greater foreign investment:

--Repeal restrictions on charges allowed by port operators for terminal handling services, and instead allow operators and shipping companies to negotiate these fees commercially, the standard practice in the shipping

industry. A [November 2006] GOI restriction effectively caused a 25 percent reduction in fees for port operators.

--Develop full capacity at Tanjung Priok port in Jakarta before considering major expansion in Bojonegara.

--Improve efficiency in container loading and general port operations.

--Focus on port development in locations closer to the Malacca Straits (including Batam), since Jakarta is too far from major international shipping lanes to serve as an international container port hub.

--Revise regulations and improve outreach to attract foreign investment to smaller ports in regional locations.

--Establish better rail links to ports.

¶18. (U) The top priorities for airport development are new terminal and cargo facilities at Soekarno Hatta International Airport in Jakarta, and construction of new airports in Medan, Makasar, and Lombok. The single largest project is the new Medan airport, for which the GOI is seeking USD 225 million in private investment. Participants noted the greatest barrier to private participation is the lack of GOI resolve to push forward on airport projects with clear timelines, citing as an example the Medan Airport project first proposed in the mid-1990s. They also stressed the importance of coordinated timing between the public and private components, such as construction of road access, runways and terminals--few companies want to invest in airports without roads leading to them.

Toll Road Development

¶19. (U) GOI speakers repeatedly emphasized that toll road construction remains a top priority. They described progress in toll road regulation in 2005, including the adoption of Government Regulation 15/2005 which ended state-owned toll road company Jasa Marga's regulatory functions and established the Indonesian Toll Road Regulatory Board (BPJT) in the MPW. However, they conceded that the MPW tendered only a small number of projects from the list announced at the January 2005 Infrastructure Summit, and that these transactions were not up to international standards. As a result, only one of six toll road sections tendered in a first group of projects in 2005 is in final negotiation. In addition, only four out of 13 toll road sections tendered in a second round have eligible bidders in the pre-qualification stage.

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¶20. (U) Participants emphasized that any viable toll road tender must give an operator the right to increase tariffs to account for inflation and currency rate fluctuations, and receive approval for such increases without delay. Under the Toll Road Law of 2004, the Minister of Public Works determines toll road tariffs, which may be adjusted only every two years pegged to the increase in the Consumer Price Index, any without any consideration of currency exchange rate fluctuation. Several participants also commended the MPW for developing a toll road master plan (which would help estimate usage in planned toll road segments), but others noted that completion of the plan by December 2006 may be overly optimistic.

Gas Pipelines May Be Promising

¶21. (U) The natural gas sector may be the most promising in the short-term for international investors, according to several forum participants. One local energy sector analyst noted that he sees tremendous potential for the downstream gas sector, but cautioned that the overriding incentive for inward foreign direct investment will be a robust upstream oil and gas sector. He noted that foreign investors would be eager to build pipelines if exploration companies are finding hydrocarbons and are able to sell their products at world market prices.

¶22. (SBU) The main practical concern for potential pipeline investors remains the certainty of gas supply. Few international banks will finance gas pipeline projects without a rock-solid guarantee of a steady supply of gas. During 2005, the downstream regulatory body BPH Migas tendered two pipeline projects, the Grisik-Semarang-Cirebon (East Java to West Java) pipeline and the East Kalimantan - West Java pipeline. With the question of gas supply unresolved due to unclear GOI guidance on a domestic market obligation (DMO) for all new natural gas projects, the two tenders have attracted little international interest. The GOI will need to clarify the DMO for future gas projects to attract foreign investors to the pipeline sector, according to many conference participants. One bright spot for the sector is that unlike state electric monopoly PLN, state gas company PGN has no credit quality issues that would inhibit potential foreign investors.

Electricity: Great Need, Much Risk

¶23. (U) Potential investors in the electricity sector told the GOI representatives that their top concerns include achieving greater regulatory transparency and predictability in tariff setting. They said a predictable revenue stream and transparent mechanism to gain GOI approval for rate increases are crucial for making projects bankable. Participants quizzed GOI panelists on the proposed risk-sharing scheme, which they said would be crucial for attracting investment given PLN's poor creditworthiness. They also expressed concern about the reliability of feedstock supply for power plants, given the uncertain nature of the natural gas DMO.

¶24. (U) Director General of Electricity and Energy Utilization at the Ministry of Energy and Mineral Resources (MEMR) Yogo Pratomo told participants the GOI will speed up the tender process for the construction of eight new power plants so that they can begin commercial operation between 2010 and 2011. He noted PLN estimates that Indonesia will need to add 6,000 MW of power each year through 2015 just to keep up with current demand. With economic growth rates rising, electricity demand is sure to rise with it.

¶25. (SBU) Pratomo said the tender for the 600 MW Cirebon

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steam power plant, opened in September 2005, is the highest priority, but that the MEMR should open tenders for seven other power plants by the end of March. These include a 500 MW combined cycle power plant in Pasuruan, East Java, a 2 x 600 MW coal-fired power plant in Jepara, Central Java, the Paiton 3 and 4 coal-fired power plants (2 x 400 MW) in East Java, a 2 x 60 MW coal-fired power plant in East Kalimantan, a 2 X 100 MW coal-fired power plant in North Sumatra, a 2 X 100 MW coal-fired power plant in Bali and a 2 X 25 MW coal-fired power plant in South Sulawesi. The quality of the tender documents for these projects is unclear--a Japanese participant in the forum told us that Japanese companies have submitted only pro forma non-conforming bids in the Cirebon tender because of the absence of any GOI risk sharing and

questions about the project design.

¶26. (SBU) Comment: The GOI did an impressive amount of homework for the February 21 forum, and in the eyes of most participants, has made up a good deal of the credibility it lost after the first Infrastructure Summit produced virtually no tangible results. But the Coordinating Ministry for Economic Affairs is proposing changes on a very large scale, and few of our contacts believe the GOI will be able to adhere to the deadlines in its policy matrix. Even so, the GOI will likely be able to keep investors' attention if it can get one or two "fast track" projects off the ground before the next infrastructure summit tentatively scheduled for June ¶2006. Even this task will be very difficult, however, and require the GOI to confront tough issues like PLN's creditworthiness, possible future electricity tariff increases, and corruption in land acquisition. If the GOI can cut through these knots and get a few deals going, we expect at least a few potential investors will take notice.

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